THE BLEYZER FOUNDATION
Turning Transitions Into Prosperity

Ukraine - Economic Situation

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Economic Growth.

As reported last month, during the eight-month period from January to August 2001, real GDP grew at a high rate of 10.8%, compared to the same period last year. This high GDP growth was led by the agricultural sector, with agricultural output increasing by 27.7% during January-August, year-to-year. During this eight-month period, formal private sector agricultural enterprises increased output by 39.3%, while smaller individual farms increased production by 20.1%, year-to-year.

The industrial sector has also performed well, though at a lowering pace. Real industrial output grew by 13.5% in July and 11.5% in August, compared to the same months last year. Industrial output grew by 16.9% during the January-August period, year-to-year. During this period, the highest rates of growth were experienced in the following industrial branches: oil refining and coke (52%), timber and wood products (32%), rubbers and plastic products (32%), machine building (25%), paper and printing (23%), and agro-industries (22%). Metallurgy and metal processing output increased by 11% during January-August, year-to-year, which allowed Ukraine to produce 22 million tons of steel in the eight-month period of 2001. This steel output placed Ukraine among the seven world's largest steel producers (together with China, Japan, the USA, Russia, Germany, South Korea, India, Brazil and Taiwan.)

The social sectors, however, have not performed as well as the economic sectors. In fact, during the eight-month period from January to August 2001, value-added in Education and Health experienced negative rates of growth of -0.3% and -1.3%, respectively, when compared to the same period last year. The proposed fiscal budget for 2002 plans to address this situation.

Fiscal Policies.

The consolidated fiscal budget for the current year 2001 continues to perform satisfactorily with the fiscal deficit under good control. This performance was achieved by a tight control of fiscal expenditures, despite the fact that fiscal revenues were below the plan.

During the period January-August, consolidated fiscal revenues reached UAH 34.8 billion (including UAH 1.7 billion of privatization receipts) or only 87% of the plan for the period. Part of this gap is explained by a shortfall of UAH 2.4 billion in privatization receipts (which were planned at UAH 4.1 billion during this eight-month period). But the gap is also due to lower tax collections due principally to the write-off of UAH 14 billion of tax debts, which was agreed upon by the Government early in this year (as estimated by the State Tax Administration and which includes tax arrears, fines and penalties). This tax write-off was expected to encourage a reduction in the shadow economy (which indeed is taking place) and greater future compliance with tax payments.

Tight control of expenditures has been able to keep the level of consolidated fiscal expenditures below the plan, at about UAH 33.3 billion for the eight-month period from January to August. Consequently, despite revenue shortfalls, the consolidated fiscal balance for January-August showed a surplus of UAH 1.5 billion or 0.7% of estimated 2001 GDP. On the basis of IMF methodology, which excludes privatization receipts, the fiscal balance for January-August was a small deficit of only 0.1% of GDP, in compliance with the agreements with the IMF.

On September 14, 2001 the Government submitted the 2002 draft fiscal budget to Parliament. The draft is consistent with the agreements with the IMF. It envisages consolidated fiscal revenues of UAH 57 billion ($10.2 billion), or about 23% of estimated GDP for 2002. The draft budget puts emphasis on the social sectors, with about 52% of Government revenues devoted to these sectors. As agreed with the IMF, the budget deficit for 2002 would be limited to 1.7% of GDP (excluding privatization proceeds of UAH 5.8 billion, which will be treated as a financing, below-the-line item, following the IMF methodology). This deficit is considered to be sustainable, based on realistic levels of domestic and foreign financing. The key assumptions behind the 2002 draft budget calculations are the following: real GDP growth of 6%, annual inflation of 9.8% and an average annual exchange rate of 5.6 UAH/US$.

Monetary Policies.

During the period January to September 2001, money supply (M3) reached UAH 40 billion, an increase of 25% since the beginning of the year (compared to an original target of 19% for the entire year). Such money supply increases have not yet led to high inflation, as inflation from January to September was only 3.7% (0.4% in September).

However, the National Bank of Ukraine estimates that the money supply increases since the beginning of the year will have a lagged effect on inflation during the last quarter of the year. During this time, inflation would also be induced by the implementation of electricity tariff increases agreed upon with the six electricity generation companies recently sold to foreign companies. For the October-December quarter, the NBU expects a quarterly inflation rate of about 9%. On this basis, the NBU estimates that inflation during the entire 2001 year will be close to its original target of 12.3%. It is unlikely, however, that these high rates would materialize.

For 2002, the renewal of lending by the IMF and the World Bank should permit the country to serve its foreign debt without a need to increase money supply substantially. The NBU therefore expects that it would be able to implement tighter monetary policies in year 2002, with money supply increasing by 19% during the year. This rate on monetary growth would be consistent with the expected inflation rate of 9.8% for 2002.

Continued good export performance and the recent disbursements of $376 million by the IMF and $150 million by the World Bank have helped to boost the level of gross international reserves of the NBU to $2.7 billion as of the end of September 2001 (or about 8–9 weeks of Ukrainian imports). This is one of the highest levels of reserves ever achieved by the NBU. In year 2002, the NBU expects to maintain its international reserves at a level of $3.2 billion. In anticipation of slowing export growth, the National Bank of Ukraine expects to obtain foreign exchange primarily from renewed lending by international agencies, from proceeds from privatization and from increased amounts of foreign direct investments.

The availability of foreign exchange has also led to a slight appreciation of the Hryvnia's foreign exchange rate. The official exchange rate of the Hryvnia has revalued from 5.44 UAH/$ at the beginning of the year to 5.33 UAH/$ at the end of September. In the open free market, the Hryvnia has been trading at 5.25 UAH/$.

Government Debt.

With the renewal of IMF lending, Ukraine should now be in a position to complete the restructuring of $580 million of its bilateral debt to some members of the Paris Club (France, Germany, Italy, Japan and the US). In accordance to the July 13, 2001 Paris Club agreement, the country should now finalize agreements with the individual member countries, under terms that would provide for maturities of 12 years, including three years of grace. These Paris Club agreements are expected to be finalized by the end of the year and no later that March 2002.

In addition, Ukraine has reached an understanding with Turkmenistan, another important bilateral creditor, on the restructuring of $280 million of gas debt. On its gas debt to Russia, the Ukrainian gas company, Naftogas Ukrainy, and Russian's Gazprom have now reached agreement to settle $1.4 billion of Ukrainian debt. This debt will be considered as a corporate liability of Naftogas, not as a Ukrainian Government debt. The terms of the restructuring would be similar to the terms agreed upon with the Paris Club: 12-year maturity with 3 years of grace.

The size of Ukraine's total external debt has been reasonable stable at the level of $9.7 billion (including IMF debt of about $1.9 billion). This level is not excessive as it represents only about one-quarter of the new GDP estimate for 2001. With the new lending recently provided by the IMF and World Bank and with the successful restructuring of other bilateral debt, Ukraine should be in a position to serve comfortably its external debt service payments. For year 2002, it is estimated that Ukraine's external debt service payments would be about $1.5 billion, including the following: $570 million due to the IMF/World Bank, $160 million due to the European Bank/European Commission, $160 million due to the Paris Club, $430 million due under Government external bonds and $190 million due to other commercial entities.

International Trade and Capital.

During the first seven months of the year, merchandise exports have continued to increase at a high rate of 19.9% year-to-year. Merchandise imports increased by 8.7%, year-to-year. During this period, goods exports amounted to $9.4 billion, while imports reached $8.6 billion. This resulted in a positive merchandise balance of $728 million, compared to the merchandise trade deficit of $137 million during the same period last year. The largest importers of Ukrainian-made goods remained Russia (25.1% of total Ukrainian exports for the period), Turkey (5.2%), Italy (5.1%), Germany (4.4%), USA (3.5%), and Poland (3%). Imports arrived mostly from Russia (37.6%), Turkmenistan (10.1%), Germany (8.6%), Kazakhstan (4.4%), and Belarus (3.1%).

IMF and World Bank Programs.

As anticipated in the last monthly economic report, on September 20th, the IMF and the World Bank agreed to restart their lending operation in Ukraine. The IMF disbursed $376 million at the end of September. The World Bank approved a loan of $250 million under the Programmatic Adjustment Loan (PAL), of which $150 million have been disbursed. The remaining $100 million is expected to be released before the end of the year pending successful progress in agreed areas of reforms.

Upon approval of its loan, the IMF indicated that it regards Ukraine's economic performance in 2001 as impressive, taking into account both rapid GDP growth and low inflation. The IMF encouraged the Government to accelerate its economic reforms to maintain growth prospects over the medium term. It highlighted the need to improve the business climate, restructure large banks, raise the transparency of the privatisation process, and accelerate the liberalization of the agricultural sector.

On the approval of its loan, the World Bank said that the loan approval intends to send a clear signal to the effect that the situation in the socio-economic sphere has changed for the better since the beginning of the year 2000. It added that Ukraine has reduced salary and pension arrears, improved cash collections in the energy sector; reduced the cost of entry and operation of businesses; transformed collective farms by issuing 6.5 million land ownership certificates and 1.3 million land titles to farm members; implemented a more transparent transfer of fiscal budget resources to the regions; streamlined public administration with reduced number of ministries; and rationalized the system of social benefits.

The World Bank's PAL program envisages as a series of three flexible budget-support loans to be executed during three years, totaling US$750 million. The second and third PALs will be presented to the Bank's Board of Directors for approval upon fulfillment of concrete economic reforms.

The approval of the IMF and World Bank loans and the restructuring of the Paris Club debt would ensure the capacity of Ukraine of servicing its foreign debt without resorting to the purchase of foreign exchange in the open markets, which have led in the past to major increases in money supply. In addition, the approval of the loans satisfies a key condition of the European Bank to proceed with its loan for the completion of the construction of reactors at the Rivne and Khmelnytskyy nuclear power plants.

All these recent developments should have a positive impact on Ukraine's international credit standing.